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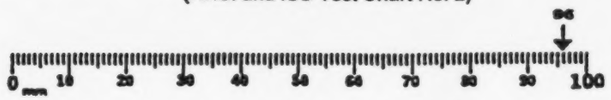

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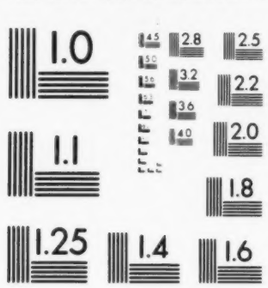

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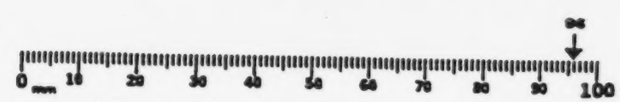

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Backgrounder

October 28, 1999

Revenue Canada Redux

by

Finn Poschmann

November 1, 1999, marks the end of Revenue Canada and the birth of the Canada Customs and Revenue Agency (CCRA). Revenue Canada is the largest federal department and touches the lives of every Canadian; its metamorphosis is no small change, and should not go unremarked.

The CCRA, Ottawa believes, will be better placed to deal with numerous stresses that have come to bear on Revenue Canada, particularly those arising over federal relations with the provinces. The new agency indeed holds tremendous promise as a vehicle for enhancing Canada's economic union. The CCRA will seek to balance competing regional and national interests by implementing the tax policies that provinces desire, while encouraging the provinces to tailor those policies to fit a nationally cohesive economic framework.

The key new feature the agency will bring to the tax scene will be its readiness to administer, free of charge, any provincial tax measures that are fully compatible with extant federal measures: this will encourage provinces to redesign many of their policies to conform to a single standard, simplifying the national web of tax regimes and reducing the compliance costs individual Canadians and businesses face. The CCRA will also administer, for a fee, nonstandard taxes and benefits. In either case, provinces that agree to hand administrative responsibility to the CCRA could save money, which — to the extent that the larger agency achieves efficiencies in managing tax collection — would reduce the net cost of government for most taxpayers.

The advent of the CCRA is thus a promising development. Yet each aspect of the agency's enticing offer to the provinces contains risks of which Canadians should beware. Risks arise, on the one hand, if the emergent tax regime becomes unresponsive to provincial aims and, on the other, if the CCRA goes too far in accommodating provincial differences over tax policy, resulting in a fractured economic union.

The first risk is that, as provinces hand over administrative responsibility for implementing tax policy, their eventual loss of ability to manage tax collection will reduce their understanding of and influence over the broader tax policy regime. Reducing the resources com-

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mitted to administering taxes will increase the difficulty provinces have in developing and maintaining the expertise needed to deliver regionally differentiated tax policies. And without the functioning administrative apparatus that would minimize the startup cost of tax collection, provincial threats to quit federal-provincial tax collection agreements will be less credible. Over time, provincial influence on the content of those agreements will correspondingly decline, and provinces may become unable to deliver the tax policies their local voters desire.

The second risk comes from the opposite direction: provinces may choose to assert their autonomy in tax policy by paying the CCRA to implement nonstandard tax measures. Consequently, it is possible the CCRA's offer to administer nonstandard taxes and benefits will stimulate a proliferation of just those things. The CCRA's administrative efficiency could make it cheaper for provinces to propose such measures, and the provinces' natural political instinct to design measures that appeal to one constituency or another will give them reason to take up the CCRA's offer. For good or ill, the new flexibility will allow more competition among the provinces in offering incentives and credits that affect business location decisions.

And the CCRA, like any other organization, will have an incentive to promote its offer to collect nonstandard taxes, for doing so will mean more revenue, more resources, and more political influence for itself and for the federal government as a whole. If the pendulum swings too far toward accommodating provincial idiosyncrasy, the uneasy prospect is that the CCRA's nation-building capacity may be used to construct a centrally administered system that is nonetheless complex, splintered, and economically inefficient.

There is no single solution to the conundrum that will confront the CCRA. But policymakers must ensure that the agency fulfills its duty to maintain a nationally cohesive system of tax administration while simultaneously respecting the duty of provinces to deliver the tax policies that their voters desire.

The Setting

The federal and provincial governments jointly occupy almost every tax field: the personal income tax, corporate income and capital taxes, and consumption (sales and excise) taxes. That fact has stimulated an extraordinary degree of coordination between the two levels of government, especially in the case of the personal income tax: all provinces except Quebec long ago handed over to Ottawa responsibility for collecting personal taxes. Most taxpayers are therefore relieved of the burden of completing two distinct income tax returns.

Seven provinces (all except Alberta, Ontario, and Quebec) have entered collection agreements with Ottawa with respect to corporate income tax, and Quebec and three Atlantic provinces have harmonized sales taxes. All the provinces have thus given up a significant degree of independence in setting their tax policies in exchange for being relieved of much of the cost of administering taxes.

The CCRA hopes to build on the example of Revenue Canada's relatively successful experience in collecting provincial personal income taxes and administering sundry credits and benefits. Provincial taxes collected under existing agreements will continue to be collected, free of charge, and the CCRA will likewise collect free of charge any new tax measures the provinces enact, provided that each new tax is fully harmonized with its federal counterpart, by way of using the same base and definitions.

As an example of harmonization in the context of the CCRA, consider a province that currently collects its own corporation income and capital taxes. It could relieve itself of the administrative burden of doing so — and remove much of the compliance costs thereby imposed on business — by switching to the federal method of assessing corporate tax

Box 1: *The CCRA's Guidelines for Administering Provincial Tax Measures*

The guidelines below are quoted from a Revenue Canada *Backgrounder*, June 4, 1998.

Minimum criteria:
The Agency will administer provincial/territorial taxes if:

- they are legally valid;
- they adhere to basic principles such as those that do not jeopardize the system of self-assessment, do not involve double taxation, and that contain generally accepted standards for fairness; and
- the Agency and the province/territory can arrive at mutually acceptable contractual arrangements.

Economic union criteria:
The economic union criteria establish conditions under which provincial/territorial tax programs will not be administered by the Agency, even if they meet the above minimum criteria. They also determine whether or not provinces/territories will be charged for the administration of a provincial/territorial tax measure.

- Discriminatory locational incentives — The Agency will not administer measures that provide a locational incentive which discriminates between provincial and territorial residents and non-residents. However, the Agency may administer locational tax incentives available to all taxpayers on a non-discriminatory basis.
- Non-harmonized measures — The Agency may administer these on a full cost-recovered basis.[a] They would include non-harmonized income tax credits or other alterations (e.g., tax on income[b]) related to taxes administered under tax collection agreements. They also include other taxes, such as corporate income taxes or provincial and territorial retail sales taxes that are not harmonized with the counterpart federal tax.
- Fully harmonized taxes —The Agency would administer these at no cost to the province/territory (based on agreements between the Minister of Finance and the province/territory). They are defined as taxes that fully replicate the federal tax and include income taxes now under tax collection agreements (the existing tax-on-tax system) and harmonized sales tax. They also include certain income tax credits that the federal government now administers on a fee basis, but which are fully harmonized, such as the political contribution tax credit.

[a] Supplementary materials attempt to distinguish between nearly harmonized measures, for which the CCRA would charge the incremental cost of administration, and nonharmonized measures, which would be billed at the average or full cost of administration.

[b] In fact, tax on income may fall in the nearly or fully harmonized category, and thus be charged at a lesser rate.

bases and calculating tax liability, and then requesting the CCRA to undertake collection.

The CCRA will also agree, under certain generic conditions, to collect a province's *non-harmonized* taxes, but it would then charge the province the cost of collection. (Box 1 summarizes the federal guidelines governing the CCRA's offer to administer tax measures.) The expectation, on which Revenue Canada's past experience gives some evidence, is that the CCRA's strengths in administration and systems automation should allow the agency to collect taxes and administer benefits more efficiently than the provinces, saving money on implementation, and potentially also saving on compliance costs, as more Canadian taxpayers will be able to do one-stop paying.

The CCRA's expanding potential to collect Canadian taxes is part of the response to the pressures that have driven the agency's creation. The tax collection agreements have often been a sore point in intergovernmental relations, with provinces chafing under federal restrictions on tax design; meanwhile, those

restrictions have sometimes been perceived to loosen only when politically convenient for Ottawa. The historical requirement that provinces levy their personal taxes as a fixed percentage of basic federal tax is an example of one such irritant, with that design feature having thoroughly entwined federal and provincial decisionmaking on tax rate and bracket structures, causing inevitable conflicts.

Thus the provinces and Ottawa have negotiated a potential solution: in future, provinces will be allowed to levy their income taxes as a percentage of individual taxable income as it appears on the standard federal tax calculation, instead of piggy-backing their taxes on top of basic federal tax. This will give the provinces more flexibility in tax design and limit the effect on them of federal decisions on tax rates; the major constraint is that the provinces will have to agree to live with the federal definition of taxable income. Alberta will be the first province to implement such a tax, beginning in 2001, and it will be administered by the CCRA.

The new flexibility in tax design will encourage provinces to remain in the tax collection agreements, rather than striking their own more disparate courses for tax policy. This is a serious issue: Ontario has repeatedly made feints toward launching its own personal income tax system and, with more than 40 percent of the nation's economy, the province is sufficiently large to implement such a system with reasonable efficiency. The western provinces, too, have made plausible threatening noises along the same lines.

Ottawa's new flexibility on policy, combined with the CCRA's offer to collect both harmonized and nonharmonized taxes, should keep the provinces happy within the collection agreements, at least initially, and lead to more efficient tax collection across the board, with lower immediate costs for government and for taxpayers. So what risks are worth worrying about?

The Problem

Ottawa has agreed to the new flexible arrangements mostly because the provinces have credibly threatened to leave the tax collection agreements. If the capacity of the provinces — Ontario, in particular — to design, implement, and collect taxes* were reduced by their signing over to the CCRA responsibility for collection, both the credibility of their threats and their ability to leave the agreements would markedly diminish.

Suppose the provinces harmonized a future tax measure, and Ottawa agreed to bear the cost of collection. Ottawa might, even in the face of concerted provincial pressure, refuse to agree to measures redefining the tax base in terms more convivial with provincial tax policy goals, or prohibit provinces from adopting modifications intended to shift the balance between family versus individual income as the basis of assessing ability to pay income tax. A province that felt this policy was too restrictive would have nowhere to turn. Leaving the agreements would entail a steep political cost, as well as an economic cost as provinces faced much larger start-up costs than they would if their tax administrations were already up and running, as they are now.

Moreover, the process for dealing with provincial policy aims would be no more open than it is now. True, the CCRA will be governed by a board of management largely selected from provincial nominees, but that board's responsibility will be national, not owed to the provinces, its powers will be narrowly circumscribed, and its capacity limited to overseeing the agency's organization and its management of resources and personnel. It will have no capacity to set policy and no authority over the enforcement of legislation.

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* In some areas, such as corporate tax policy, the provinces have not always and everywhere maintained the analytical capacity to deal with complex tax issues. In other areas, such as retail sales taxes, they generally have done so.

So, while the CCRA will remain, correctly, accountable to the Minister of National Revenue, and through the minister to Parliament, provinces dissatisfied with the interpretation Ottawa places on their agreements will have nowhere ultimately to turn but to the federal cabinet, just as they did before.

The same issues pertain to the CCRA's collecting nonharmonized provincial taxes. Provinces and taxpayers may gain through improved administrative efficiency and lower compliance costs, but provincial governments ultimately will lose leverage over broader tax policy questions, as their expertise in designing, managing, and collecting their own taxes withers.

For example, the CCRA's authority to work with provincial income tax systems, in combination with its administration of nonstandard credits, would allow Quebec to implement much of its very nonstandard tax regime through the federal agency. But Quebec certainly could not entirely duplicate its system by way of the CCRA, especially those aspects that affect the definition of the tax base. And there is no reason to expect that Quebec — were it to hand Ottawa responsibility for collecting taxes and effectively shut its own revenue ministry — would have more influence over national tax policy than it does now.

In any event, the big problem will not be the loss of provincial influence over tax administration and policy. The real issue with the CCRA's offer to administer nonstandard taxes and benefits is that provinces might hold back from implementing variegated and complex tax initiatives because administering them is expensive, and they divert resources from more profitable uses.

For example, Ontario has proposed implementing a research employee stock option credit, intended to relieve the provincial tax burden on capital gains arising from Ontario-based high-tech employees' stock options. This rather complex and interprovincially divisive measure clearly would not be easy to harmonize with federal measures, and its implementation would be legislatively and technically difficult and likely cause interprovincial misallocation of human and financial resources.

It is possible that the measure as written is inconsistent with the existing tax agreement, meaning Ontario would have to take the costly step of leaving the income tax collection agreement if it were to push ahead. Meanwhile, it is unlikely that the CCRA's guidelines could be read broadly enough to permit the agency to administer such a credit program.

But Ontario might be tempted to go ahead all the same if it could use the CCRA's administrative efficiency to deliver the program, even if the province then pays the agency's cost of doing so. The obvious expectation, which in part drives the CCRA's offer to administer nonstandard tax measures, is that the agency will be able to lower the net cost of delivering just this sort of program.

There is, of course, no reason for concern about provinces choosing their own tax rate schedule, with an eye to delivering the degree of progressivity in the tax burden their voters support. But there is every reason to worry about provincial tax policy that distorts natu-

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Quotation with appropriate credit is permissible.

ral business activity and prevents resources from being directed to their most valued uses, which Ontario's plan could do. That would clearly be damaging to Canada's economic union, and the overarching design of tax system administration should include incentives aimed at improving, rather than degrading, the union. The CCRA must carefully follow its guidelines and say no to administering such measures, even for a fee, and even when it has an institutional incentive to do otherwise.

If the CCRA, intentionally or not, lowers the cost of delivering complex and geographically splintered taxes, then the likelihood of Canada's finding itself with just such a tax regime correspondingly increases. And this may result in real economic harm, because the true cost of taxation is not (just) the administrative cost, but includes the potentially much larger cost of the economic distortions taxes cause. If the result is more, rather than fewer, taxes and tax bases, the CCRA's administrative savings will not help.

What to Do

The CCRA thus enters life as a conflicted creature. Its very aim is to entice the provinces into a single national tax administration, the outcome of which may be very positive for Canadians. But the agency also has an institutional incentive to "build the business" and to agree to implement the potentially exotic tax policy confections provinces might dream up. While the provinces have every right to seek to implement the policies their voters apparently want, if a national agency makes implementing those policies easier than it should be, then regionally splintered (but centrally administered) tax policies may be the outcome more often than Canadians want or need.

What, then, should be done?

Ottawa: Makers of federal tax policy should ensure that the CCRA does not become a vehicle for the efficient delivery of economically inefficient taxes. This means that the agency must not agree to administer tax measures that discriminate among the provinces with respect to the allocation of physical, human, or financial resources. In particular, the CCRA must fight the temptation to be liberal in interpreting its mandate to collect nonharmonized taxes, despite the fact that giving in would mean control over more resources, and more responsibility and control for itself and for Ottawa. Meanwhile, the lack of a formal channel for dealing with provincial concerns about tax policy implementation — particularly those surrounding the definition of the tax base — will remain a problem area for the CCRA.

The provinces: Provincial governments must be wary of the implications of their handing to the CCRA extensive control over the administration of their tax initiatives, since this eventually will limit their ability to implement their own tax policy, and leave them with less leverage in the political process than they now have. Although less provincial control may, in fact, be a positive outcome if it increases the national efficacy of tax policy choices and their implementation, to the extent that the provinces' hands are tied they will be less able to respond to the tax policy goals their voters may wish to pursue.

The CCRA management board: Although responsibility for decisions on implementing tax policy will rightly remain with the Minister of National Revenue and, ultimately, Parliament, the CCRA management board should regard its mandate as including a positive role in developing an agency structure that balances competing interests — namely, a national interest in developing cohesive, economically efficient tax policies that are effectively administered, and a regional interest in the freedom to establish provincial tax policies that reflect the goals and wishes of their electorates. Provincial governments have an additional role here, in ensuring that their nominees to the

board continue to have the managerial skill and the intellectual authority carry out that difficult job.

And as for Canadians in general, *caveat emptor*. The CCRA will be the focus of many of the same pressures to which Revenue Canada was subjected, but the new agency will have new policy tools with which to respond to them. Nevertheless Canadians, their governments, and policy advisors all must keep an eye on the agency to ensure that it implements policy in a manner that redounds to the benefit of taxpayers.

The balance between national and regional goals is always a difficult one to maintain. Skillful management may, however, prevent the struggle for balance from turning into a more destructive battle for political dominance. If the CCRA improves on Revenue Canada's record on intergovernmental tax policy coordination, and if the result is better economic outcomes for all Canadians, the agency will be judged successful in achieving that balance.